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Nos. 482 and 483

In the Supreme Court of the United States

OCTOBER TERM, 1928

HARRY H. WEISS, COLLECTOR OF INTERNAL REVENUE,
PETITIONER

v.

J. HARRY WIENER

C. F. ROUTZAHN, COLLECTOR OF INTERNAL REVENUE,
PETITIONER

v.

J. HARRY WIENER

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR RESPONDENT

STATEMENT OF THE ISSUE

The issue is the right of the respondent to take a deduction from gross income, in the process of computing net income taxable under the Revenue Act of 1918, of a reasonable allowance for exhaustion, wear and tear, including obsolescence, of buildings used by him in his

business, held by him under ninety-nine year leases, renewable forever, *the leases imposing the burden of such exhaustion, wear and tear and obsolescence upon him.*

The respondent claims that he is entitled to take such deduction. The Government denied it and collected taxes upon his net income increased by the amount of such deductions claimed by him.

THE ESSENTIAL FACTS

The brief for the petitioners discusses the facts in some detail. It is unnecessary to repeat them all here, but it may be pointed out that:

The respondent is in the business of holding property under long-term leases and subletting it for lesser terms for occupancy by or under the sub-tenants.

The leases under which the respondent holds are for ninety-nine year terms, with the option of renewing forever.

Under all of the leases, the respondent (hereinafter frequently referred to as the lessee) is obligated to pay stated rentals, and in addition, to pay all taxes, assessments, public charges and other charges, liens, penalties and the like, against the leased premises. (Reference "R" is to the printed transcript of Record.)

> "(Lease A (R 37); Lease B (R 38); Lease C (R 39); Lease D (R 39); Lease E (R 40); Lease F (R 41); Lease G (R 42); Lease H (R 43); Lease I (R 43 and R 49); Lease J (R 44); Lease K (R 45); Lease L (R 45); Lease N (R 47).)"

In the following leases, there is an express provision that loss of the buildings through any cause shall not relieve the lessee from his obligation under the lease:

"(Lease A (R 38); Lease B (R 38); Lease C (R 39); Lease E (R 40); Lease H (R 43); Lease I (R 44 and R 56 Sec. XI); Lease L (R 46).)"

Under all of the leases, the lessee is required to carry insurance, the avails from which, in the event of the destruction of the buildings, are to be used in replacing the buildings so destroyed.

"(Lease A (R 37); Lease B (R 38); Lease C (R 39); Lease D (R 40); Lease E (R 40); Lease F (R 41); Lease G (R 42); Lease H (R 43); Lease I (R 43 and 44 and also R 52); Lease J (R 44); Lease K (R 45); Lease L (R 45); Lease N (R 47).)"

Under the following leases there is a specific clause that if lessee raze, remove or improve the building, he must replace it with one having a certain measure of value referred to in the lease:

"(Lease A (R 38); Lease B (R 38); Lease C (R 39); Lease D (R 40); Lease E (R 40); Lease F (R 41); Lease G (R 42); Lease H (R 43); Lease I (R 44 and R 51 Sec. V); Lease K (R 45); Lease L (R 46 - Sec. V); Lease N (R 47).)"

In the following leases, there are specific covenants requiring the lessee to erect a new building or to make certain improvements in a stated time:

"(Lease D (R 40); Lease F (R 41); Lease G (R 42).)"

In the following leases, express covenants of per-

petual maintenance of buildings are contained in these leases:

> "(Lease H (R 43); Lease I (R 44 also R 51 Sec. IV); Lease J (R 44); Lease L (R 46).)"

The typical lease is lease I, which, as Exhibit B is set forth in full, (R 47 to 60). As to this lease, the stipulation of facts says (R 36):

> "VIII:
>
> The leases referred to as being for ninety-nine years, renewable forever, were thirteen (13) in number and the material points in the said leases are as set forth in Exhibit A hereof" (R 37 to 47).
>
> "IX:
>
> There is attached hereto, as Exhibit B, a sample form of said leases, which may be considered as typical of all the leases subject to the changes and modifications as shown in Exhibit A hereof."

As above stated, the express covenants of the lessee in the improvement and maintenance of the buildings on leased property, vary in the above leases. The express covenants, of course, are for the benefit of the lessor, who may insist on their performance, and, if the lessee fail to perform these covenants, the lessor may declare a forfeiture of the lease.

The stipulation as to lease of properties states:

> "It is further stipulated that all of the properties herein were leased by the plaintiff to various parties, each of which sublessees used the said property for business purposes, in

which business the plaintiff was not interested." (R 34).

The respondent was required under the terms of these leases, to pay rent to the lessor continuously. In order to realize this rent from the sublessees, it is obvious that habitable and suitable buildings must be kept upon the premises, or the resources from which the rents payable to the landlords of the lessee (respondent) could not be realized.

The respondent, therefore, if he would meet his overhead, namely, of paying rent to his landlords under the various leases, of paying taxes, assessments, insurance premiums, and other necessary expenses, must maintain such buildings on the leased premises as will enable him to realize rentals from these sublessees.

This economic necessity was continuous and inexorable, and even in those cases where a lease did not specifically require him, under pain of forfeiture, to maintain a building of a measured value, the necessity for such maintenance by the respondent was present, and his loss through depreciation was just as real as where there was a specific covenant in the lease for continuous maintenance.

This economic necessity, existing both in those leases where no express maintenance covenant to a required value and in those where such covenant is contained, required the respondent

1. At all times to maintain on the premises buildings which were adequate to produce sufficient revenue,

2. To restore such buildings when they were destroyed.

3. To replace buildings, when, through depreciation, they were worn out and obsolete, and therefore incapable of producing adequate revenue.

That this depreciation is not speculative is recognized in the statement of Facts: (R 36).

"VII:

It is agreed that if the Court shall find that the plaintiff is entitled to deductions under the terms of the Revenue Act of 1918 for exhaustion, wear and tear of buildings upon land held under leases for 99 years, renewable forever, the amounts to be refunded to the plaintiff are as follows:

For 1918	$ 22.78
For 1919	1283.10
For 1920	356.06

"If the Court shall find that plaintiff is entitled to judgment, judgment shall be rendered against C. F. Routzahn as collector in the sum of $409.09 with interest, and against Harry H. Weiss as collector for the sum of $1,252.85 with interest."

The lessee in filing his income tax returns, reduced his gross income by a reasonable allowance for exhaustion, wear and tear and obsolescence of the buildings so used by him in his business. The Government disallowed these deductions, increased his income accordingly, and computed additional taxes on the income so increased.

The District Court rendered judgment for the Government. The Circuit Court of Appeals reversed this judgment. The Government brings the case here on a writ of certiorari.

RESPONDENT'S POSITION

We claim that for the purpose of claiming a reasonable allowance under Section 214 (a) (8) of the Revenue Act of 1918, reference should be made to the exhaustion, wear and tear and obsolescence of all property used in the business, whether title be in the lessor or the lessee, whether the lessee has previously paid for such property or must pay for it in the future, *so long as the burden of making good that exhaustion, wear and tear, and obsolescence is upon the lessee.*

SUMMARY OF ARGUMENT

I. Depreciation is allowed to a taxpayer out of current income, otherwise the investment which produces that income will become exhausted. *United States v. Ludey*, 274 U. S. 295.

> The proceeds of a sale of goods represents a return
>
> 1. On the materials entering into the production,
>
> 2. On labor that has been applied to goods, including the effort of executives and salesmen,
>
> 3. On the proportion of the value of the machinery,
>
> 4. On the buildings, which is consumed in the manufacture of the product; and
>
> 5. In some cases, on a proportionate part of the monopoly granted, as patents, existing during the period of production.

The manufacturer must recover these elements of basic value before he has received income upon the sale. It will be shown in this argument, that a lessee under a ninety-nine year lease renewable forever, who

sublets the buildings on the leased property "sells" to the sublessees, a composite of various elements, among which is the depreciation of the building which is consumed in the business of renting, over a period of years, just as the machinery and buildings of the manufacturer are consumed in the process of manufacturing the product which is sold.

II. The Deduction Should be Allowed to the Taxpayer Who Must Bear the Loss. The annual depreciation of a building on a perpetual leasehold, causes loss to the lessee, not to the lessor. Rentals are fixed in leases of this type, on the assumption that the lessee will pay rent continuously and the lessor is not concerned with the maintenance of the buildings.

III. For the Purpose of the Tax Law, the Lessee is the Owner. *Ralston Steel Car Co.* v. *Ralston*, 112 Ohio State 306.

A. Every Reason for Allowing the Deduction to an Owner Operating His Own Property, Applies Equally to the Lessee in the Present Case. As with an owner, a part of the revenue received from a building which a tenant under a perpetual leasehold sublets, reimburses the owner or lessee for a part of the capital which is lost by depreciation in the year when the revenue was produced. This reimbursement from revenues is a recovery of capital. It is not income.

B. Every Reason for Denying a Reduction for Depreciation to a Lessee Would Apply Equally to an Owner. If an owner sells a building before he has replaced a depreciated building, he will receive a diminished purchase price. If a lessee under a permanent leasehold sells his leasehold

> rights, before he has restored a depreciated building, he receives less for his leasehold than if the building had been restored. If the lessee under permanent leasehold surrenders his lease to the lessor, and the building on the property is depreciated, in some way or other he will have to account to the lessor for the amount of depreciation. Otherwise, the lessor may hold him to his bargain, namely, continuously to pay rent.

IV. There is No Authority for the Government's Position. The cases cited by the Government are not authority for the proposition for which they are cited and the interpretation which the Government has placed upon the cases upon which it relies, is not borne out by the facts.

ARGUMENT

I.

NATURE OF "DEPRECIATION"

The Revenue Acts and the Treasury Regulations thereunder have uniformly recognized the necessity of an allowance for "depreciation" in determining taxable income. Gross receipts are not all income. Only after gross receipts have been reduced by the capital return represented therein and the expenses of obtaining them can any *gain* be determined. *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179. And only *gain* is income within the meaning of the Sixteenth Amendment to the Constitution. *Eisner* v. *Macomber*, 252 U. S. 189.

The deduction from gross receipts for "depreciation" was recognized by this Court under the tax laws of 1864 and 1866. *Little Miami, etc. R. Co.* v. *U. S.*, 108 U. S. 277.

In the Corporation Excise Tax Act of 1909, it was provided:

> "Second. Such net income shall be ascertained by deducting from the gross amount of the income of such corporation * * *, received within the year from all sources, * * * (second) all losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any * * *."

The 1913 Act provided (Sec. G (b)) for a deduction of:

> "(Second) all losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation by use, wear and tear of property, if any * * * *."

The 1916 Act used the same words with respect to losses (Sec. 12 (a) second), but continued:

> "including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade;"

The 1918 Act separated this deduction from that for losses, providing (Sec. 214 (a) 8) for the deduction of:

> "A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business including a reasonable allowance for obsolescence."

It should be noted that although the term "depre-

ciation" disappeared with the Act of 1913, and the deduction was separated from that for losses in the Act of 1918, the thought underlying the allowance of the deduction was the same throughout all the acts, with the exception that depletion was not provided for in the Excise Tax Act of 1909 and was included by the use of the term "exhaustion" in the later revenue acts (*Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364;) as well as by specific reference.

Treasury Regulations 45, promulgated under the Revenue Act of 1918, contained the following:

> "Article 161. *Depreciation.* A reasonable allowance for the exhaustion, wear and tear and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a consistent plan by which the aggregate of such amounts for the useful life of the property in the business will suffice, with the salvage value, at the end of such useful life to provide in place of the property its cost, or its value as of March 1, 1913, if acquired by the taxpayer before that date."
>
> "Article 162. The necessity for a depreciation allowance arises from the fact that certain property used in the business gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to

> wear and tear, to decay or decline from natural causes * * * . Property kept in repair, may, nevertheless, be the subject of a depreciation allowance * * * * * ."

This Court, in *Von Bombaugh* v. *Sargent Land Co.*, 242 U. S. 503, interpreting the Act of 1909, said:

> "What was here meant by depreciation of property? We think Congress used the expression in its ordinary and usual sense as understood by business men. It is common knowledge that business concerns usually keep a depreciation account, in which is charged off the annual losses for wear and tear, and obsolescence of structures, machinery, and personalty used in the business."

The same thought was well expressed in *San Francisco, etc., Co.* v. *Scott*, 253 Fed. 854, 855, where the court said:

> " 'Depreciation' as used in the statute is not to be confused with ordinary repairs. It is intended to cover the estimated lessening in value of the original property, if any, due to wear and tear, decay, or gradual decline from natural causes, inadequacy, obsolescence, etc., which at some time in the future will require the abandonment or replacement of the property, in spite of ordinary current repairs."

The allowance is to cover the lessening in value which cannot be made good by ordinary repairs and minor replacements, the cost of which is separately deducted from gross receipts under different provisions of statute and regulations.

The theory of allowing the deduction is that in the

use of the property, a gradual sale of it is made. The Board of Tax Appeals in discussing the nature of and reason for this deduction in *Appeal of Even Realty Co.*, 1 B. T. A. 355, 359, said:

> "When a manufacturer sells his product he is really selling a composite of four or five things: (1) The materials entering into the product; (2) labor that has been applied to them, including the effort of executives and salesmen; (3) that proportion of the value of the machinery and of (4) the buildings which is consumed in the manufacture of the product, and (5) in some cases a proportionate part of the monopoly granted by patents, exhausted during the process of production. Until the manufacturer has recovered the cost or basic value to him of the proportionate parts of these items attributable to a unit of his product sold, he can not properly be said to have received income upon its sale, and only the excess of the sale price realized over the sum of these items (whatever particular form they may take) is truly income. We feel that this would be true whether the statutes made any specific provision for their deduction or not—the computation would be just as necessary to the determination of true income as the computation of profit on a sale by reference to the cost or basic value of the article sold. As the Supreme Court said in *Doyle* v. *Mitchell Bros. Co.*, *supra* (247 U. S. 179), at p. 188:
>
> "'It may be observed that it is a mere question of methods, not affecting the result, whether the amount necessary to be withdrawn in order to preserve capital intact should be deducted from gross receipts in the process of ascertaining gross income, or

> should be deducted from gross income in the form of a depreciation account in the process of determining net income. In either case the object is to distinguish capital previously existing from income taxable under the act.'
>
> "Because of the difficulty of attributing to each article sold or to the sales in a taxable year an exact sum representing the proportion of basic value of machinery, buildings, patents, etc., entering into such sale, the statutes have consistently provided for a *reasonable allowance*. • • • "

This opinion was cited by this Court in *United States* v. *Ludey*, 274 U. S. 295, where the Court confirmed the Board's reasoning in the following terms:

> "The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. • • •
>
> "Such being the rule applicable to manufacturing and mercantile businesses, no good reason appears why the business of mining should be treated differently."

That the deduction of an allowance for "depreciation" is essential in the computation of taxable income was settled beyond discussion by this Court in *Knoxville* v. *Knoxville Water Company*, 212 U. S. 1, 13, where it said:

> "Before coming to the question of profit at all, the company is entitled to earn a sufficient sum annually to provide not only for current repairs, but for making good the depreciation and replacing the parts of the property when they come to the end of their life. The company is not bound to see its property gradually waste, without making provision out of earnings for its replacement. It is entitled to see that from earnings the value of the property invested is kept unimpaired, so that, at the end of any given term of years, the original investment remains as it was at the beginning. It is not only the right of the company to make such a provision, but it is its duty to its bond and stockholders, and, in the case of a public service corporation, at least, its plain duty to the public."

The suggestion made by the Government under the second point in its brief that the Circuit Court of Appeals erred in assuming that depreciation would occur and that replacements or extraordinary expenditures chargeable to capital investment would partially renew it, constitutes an attack on the Government's own definition of depreciation as contained in Articles 161 and 162 of Regulations 45. There is no dispute as to ordinary repairs. The Government has allowed their deduction. Replacements and renewals, however, cannot be made from day to day although the depreciation which necessitates them does occur from day to day.

It is true that the lessee has contracted to maintain

the property in the condition in which it was received. But what does that mean? Does it mean that every time a thousandth of an inch of the surface of a floor is worn off, the lessee must make replacement? Does it mean that roofs must be repainted after every rain? Does it mean that if a certain building has a normal life of fifty years, it must be replaced every day, or every year, or every ten years? Certainly not. But the wear and tear goes on from day to day, and nobody can say that any building in use is in the same condition today that it was a month ago.

If a building with a fifty-year life were taken over, new, under a lease, and after a year the lease were terminated (e. g., for default in rentals), would the lessee have to replace it with a new building, and keep or sell the materials of the old? No court would make any such requirement. Equity does not grant specific performance of such contracts. The contract would be held to mean that the lessee is responsible in money damages for the difference between the value of the building returned and the value of a new building.

II.

THE DEDUCTION SHOULD BE ALLOWED TO THE TAXPAYER WHO MUST BEAR THE LOSS.

It should be noted that neither the statute nor the regulations (see pp. 10 and 11, supra) indicate that the allowance is restricted to the person who holds legal title to the property, the person who owns the property, the person who has paid for the property, or the person who has made a prior investment in the property. The deduction is allowed by reference to "*the property used in the trade or business.*"

This is because it would be wholly illogical to re-

strict the deduction otherwise than as actually done by statute and regulation.

To restrict the deduction to the holder of legal title to the property would be absurd—for legal title is frequently held merely as security for the payment of money or the performance of some other contractual obligation. A mortgagor, using up machinery or buildings in his business, should not be denied a depreciation allowance, merely because legal title to the property is vested in the mortgagee. One who has purchased property on credit and uses it up in his business should not be denied the allowance because he has not paid for it in full. He has made himself responsible for payment, and the revenue he receives from the use of the property includes a proportionate part of its cost, whether he has prepaid that cost or promised to pay it in the future.

The Treasury Department has never hesitated to allow depreciation to mortgagors or to purchasers on credit. The use of the word "cost" in the statute and regulations has never been held to mean prepaid cost or prior investment by the taxpayer in such cases. Nor could this Court have so intended to use the word "cost" in the opinion in *U. S.* v. *Ludey*, quoted above (p. 14).

The right to the deduction is based upon the use of the property in the business—the language of the statute and the regulations, and common sense indicate this. Obviously the statutory words "used in the trade or business" mean the trade or business of the taxpayer claiming the deduction, not the trade or business of another.

When A leases property to B under such circum-

stances that B pays nothing but a fixed rental for the property, and A must make good the depreciation out of rents received, the property is used in A's business of renting property. The deduction should be allowed to A. This occurs in ordinary short term leases. If A owns land worth $50,000 and a building thereon worth $100,000, having a normal life of 50 years, and leases it for three years to B, he will exact a rent (depending of course on market conditions) of about $15,000. He arrives at this figure by adding together:

6% on $150,000 investment	$ 9,000
Estimate for real property tax	2,500
Estimate for current repairs	1,500
Reserve for depreciation	2,000
	$15,000

B will pay $15,000 rent and will deduct it all from his receipts from operating the building, in computing his taxable income. In effect he will be paying for the depreciation and will be allowed to deduct it. But A, receiving $2,000 for depreciation as part of his "rent" will deduct that amount from his gross receipts as a depreciation allowance; in computing his taxable income.

But if A leases to B on terms similar to those in the case at bar (common enough in long term leases) he will exact a "rental" of only $9,000, representing merely six per cent on his $150,000. B will agree to pay not only the $9,000, but also:

the real property tax	$2,500
current repairs	1,500
depreciation	2,000
	$15,000

To be sure he does not agree to pay the $2,000 for depreciation in each year, but he agrees to replace the building when it is worn out with one equally good *and equally valuable*, and the expected cost of it, spread over the life of the building he is using up, will amount to $2,000 a year, which he will set aside out of his receipts from the operation of the building in the form of a depreciation reserve. The cost of the building is part of the consideration he must pay for the right to occupy it and to use up its value. The fact that he will actually disburse it at the end of fifty years, rather than currently, is no reason why, under sound accounting, he should not attribute that cost ratably to the years in which he is in effect *selling the building*.

The building is obviously used in B's business. *Flint v. Stone Tracy Co.*, 220 U. S. 107, 171. B is the man who must pay for the depreciation. He should be allowed to pay for it out of his receipts from its sale, *as he sells it*. Only in this manner can he fairly reflect his annual income—for so much of his receipts as represent a return of the capital value of the building *are not income*.

There is no sound reason why B's annual deduction for rent (consideration for the use of the building) should be $15,000 in case of the short term lease but his aggregate deductions for the consideration he must pay for the use of the building under the long term lease should be only $13,000, when actually he pays the same under each.

The Government in its brief suggests that the depreciatiop deduction must be allowed to the lessor, and therefore cannot be duplicated in computing the lessee's income. The author of that brief was apparently

unaware of the fact that the Treasury Department regularly (and rightly) refuses to allow lessors any depreciation deduction where the lessee undertakes to make good the depreciation. That the Treasury is right in refusing this deduction to the lessor is obvious, for the lessor should not be allowed a deduction for a loss for which he will receive full restitution, or for a return of capital which will be restored to him by the lessee.

A common form of long term lease is that made between railroad companies. The lessor company turns over its entire property to the lessee for a long term —much longer than the life of any of the buildings, roadbed, or rolling stock. It receives a net rental in the form of dividends on its stock—which are *all income*. The lessee pays for repairs, taxes, and depreciation (through replacement). The property is used in the business of the lessee, and in its business *only*, for the lessor ceases to be "in business" (*Minehill & Schuylkill Haven R. C. Co.*, v. *McCoach*, 228 U. S. 295.) The lessor certainly could not claim a deduction for depreciation of property used in its business when it is not in business, nor *should* it be allowed a deduction from the dividends paid on its stock which are 100% pure income.

The Corporation Excise Tax Act of 1909 and the Revenue Acts of 1913 and 1916 classified the depreciation deduction with *losses* (see quotations on p. 10, supra). The more recent view is that it represents a return of capital. *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179; *U. S.* v. *Ludey*, 274 U. S. 295. But under either view the result should be the same. If the deduction be regarded as one for a loss, it should be allowed to the

one who must stand the loss. If it be regarded as a return of capital, it should be allowed to the one who must make good the capital.

Even if we admit for the purposes of argument that the capital recovered is that of the lessor and not that of the lessee, that part of the gross receipts from operating the building which represents proportionate cost as the building is sold (applying the reasoning of the *Ludey* case) is not income at all. And it should be eliminated from taxable income either in the process of computing gross income from gross receipts or in the process of computing net income from gross income. *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179. If A pays $100 for an article and authorizes B to sell it for him, and B sells it for $120, the $100 is not income to anybody, regardless of how the $20 gain may be divided between A and B. Nor would the $100 be income to B if A allowed him to retain it for the purpose of investing it in a new article to be returned to A at the end of a stated period. And the situation is not changed if the sale by B is to be made over a period of years rather than all at once.

The taxability of income to the person to whose benefit it accrues is not dependent upon the ownership of the capital from which the income is derived. Nor, if it is derived from labor, upon the personal performance of that labor. A may rent B's capital or hire B's services and make income therefrom upon which he will be taxable. There is no reason why deductions should follow a different rule. The test of whether A can claim a deduction for depreciation should not depend upon his title to the depreciating capital, but upon whether it is used in his business and whether

the wear and tear or obsolescence of the capital actually does reduce his income.

A position similar to that taken by the Treasury Department was at one time taken by it with respect to depletion. Form AM-M-MS, entitled "Schedule for Depletion, 1909 to 1917," declared that under none of the Acts of 1909, 1913 or 1916 was a lessee entitled to deduction from income on account of depletion (see *Lynch* v. *Alworth-Stephens Co.*, 294 Fed. 190, 195). This rule was arbitrary and without foundation in law, for the statutes made no distinction between owners and lessees. This Court held (*Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364; 45 Sup. Ct. 274) that lessees were entitled to deduct depletion. This Court further held that while "depreciation" under the Corporation Excise Tax Act of 1909, did not necessarily include depletion of mines, under the 1916 Act the term "exhaustion" did include depletion, further reference to depletion in the statute being for the purpose of limiting the amount of the deduction allowable. It follows that what is true of depletion—i. e., that it may be taken by a lessee—is true of "exhaustion" generally, or of "wear and tear" which is treated identically by the statute. As this Court said in *U. S.* v. *Ludey*, 274 U. S. 295: "In essence, the deduction for depletion does not differ from the deduction for depreciation."

The Government, in its brief, has spent a great deal of time in discussion of the terms of the leases; see brief pages 14 to 19 inclusive. The Government in this summary, has considered only one feature of the obligation of the lessee under a ninety-nine year lease renewable forever. We submit that this obligation is of two kinds:

1. Express covenant in a lease to restore buildings or to maintain them of a stated value, under pain, in case of the non-performance, of the forfeiture of his leasehold,

2. That obligation which rests upon every lessee in a lease of this kind, regardless of the express covenants to maintain buildings or to restore them to a stated value, of paying the annual rate to his landlord, in a case such as is presented in the two actions under consideration.

This latter obligation is one which creates a constant economic necessity upon the lessee, to keep the buildings on the leased premises in such condition that they will constantly produce an adequate revenue so that he may

1. Pay the rent to his landlord,
2. Pay the taxes and assessments,
3. Pay insurance premiums,
4. Pay for repairs and upkeep of the building and any other miscellaneous expenses, and
5. Provide for a sufficient return so that he may ultimately replace the buildings, and
6. Provide for a profit to the lessee under the permanent leasehold.

It is submitted that it is only under heading "6" that income is produced. One to four inclusive are current expenses. Five is his return of capital. It is necessary for the lessee to realize one to five inclusive before he has any profit at all. He must keep up the buildings and if they are destroyed or become obsolete or depreciate so as to be unfit for subletting, the lessee will then be unable to meet his obligations under items one to four inclusive. The lease requires him perpetually to

meet items one to four inclusive. He is then under the economic necessity of providing for item five and unless he does, he will face an annual deficit. His revenue, then, should be adequate to enable him ultimately to build a building to replace the one which is suffering depreciation. This economic necessity is as much an obligation as if it were both in the form of a covenant, and contained in the lease in such form as to enable the lessor, if there be a breach of covenant, to declare a forfeiture of the lease. The lessee under a ninety-nine year lease renewable forever, is under the same obligation to restore the buildings which depreciate, whether the lease specifically requires him to maintain buildings of a given value or not. He is required perpetually to pay rent under all hazards, whether the building is destroyed, depreciates or not. Business judgment therefore requires that he provide against depreciation.

The Government states on page 12 of their brief, "The decision of the Circuit Court of Appeals was not correct in allowing a deduction to be taken under the leases when it was possible that they would never require any capital expenditures to be made." This is a fallacious statement. It would not be possible to conceive of a case where, in the course of years, the lessee under a perpetual leasehold might be relieved from the necessity of making capital expenditures. As long as the lease requires him perpetually to pay rent and as, in this case, his revenue is from a business involved in subletting the leased premises, the tenant for ninety-nine years renewable forever, can never relieve himself from the obligation of making such capital expenditures as are necessary to restore the premises when they have depreciated. Otherwise, he faces

ruin. What the Government meant to say, was that, in some of these leases, there was no covenant on the part of the lessee to maintain buildings of a stated value. Of course, if there is no such covenant, the lessor cannot forfeit the lease for non-maintenance of values nor for non-restoration of buildings. However, a tenant who is required perpetually to pay a stated rent which, as in this case, is to be obtained from the business of subletting, is under the same duty to himself to maintain the earning power of the buildings on the premises, as the owner in fee simple is under a duty to himself to maintain the earning power of the buildings upon premises which he owns in fee. To say that it might not be necessary that the lessee restore the buildings, is to ignore the physical facts of wear, tear and change.

III.

FOR THE PURPOSES OF THE TAX LAW THE LESSEE IS THE "OWNER."

As we have shown above, legal title in the taxpayer is not a prerequisite of the deduction for depreciation, otherwise it could not be allowed to mortgagors, or to conditional purchasers where title is in the vendor. If we assume for purposes of argument that the deduction can only be allowed to a beneficial owner, we are immediately confronted by the question of who is the beneficial owner under a lease for a term longer than the life of the depreciable property. A mortgagor remains the beneficial owner so long as he lives up to his covenants and avoids foreclosure. The lessee for ninety-nine years (renewable forever) of a building having a life of fifty years, is just as much the benefi-

cial owner as the mortgagor. So long as he pays his rent and otherwise performs the obligations of his covenants, he is entitled to possess the property, to use it and to use it up, and he is saddled with all the burdens of ownership. By the terms of the lease he has assumed the payment of the taxes on the property, he has assumed the risk of the destruction of the buildings by fire or storm, and he has assumed the loss resulting from the gradual effects of the elements as well as wear and tear. So long as a mortgagor meets his obligations, he is the beneficial owner of the property. So long as this lessee meets his obligations, he remains the beneficial owner of the buildings—for a term longer than their life.

These buildings are located in Ohio, and the Ohio courts regard the lessee under a lease of this character as the owner of the property. See *Ralston Steel Car Co.* v. *Ralston*, 112 Ohio State 306.

The Supreme Court of Ohio said in *Stevenson* v. *Haines*, 16 Ohio State 478, that the legal effect of such a leasehold

> "is to pass to the grantee an estate in fee simple, subject to be defeated by the non-payment of annuities denominated in the instrument 'rents and charges' * * *. In other words, the transaction was equivalent to a sale and conveyance, with a mortgage to secure the payment of the purchase money."

There are many other cases in the Ohio reports to the same effect, but, since they are all summarized in the *Ralston* case, we shall not detail them here. That the Ohio courts are not unique in this holding can be

seen by comparing *Crowe* v. *Wilson*, 65 Md. 479, 5 Atl. 527.

In *Putzell* v. *Drovers etc. Bank*, 78 Md. 349, 28 Atl. 276, the court said:

> "It is well settled that the holders of such leases have the absolute control and management of the property; they usually have, in point of fact, far more valuable interests in it than the reversioner who holds the estate of inheritance."

Under general tax laws providing that property should be taxed to owners thereof, it was held that the lessee and not the lessor was the owner. *Ocean Grove Camp Meeting Association* v. *Reeves*, 79 N. J. Law 334, 75 Atl. 782 (aff'd 80 N. J. L. 464, 79 Atl. 1119); cf. *Anderson* v. *Morris* and *Essex R. R. Co.*, 216 Fed. 83, 91; *Black* v. *Delaware Raritan Canal Co.*, 24 N. J. Eq. 455, 465; *Brainerd* v. *Colchester*, 31 Conn. 407.

Tiffany, Landlord and Tenant, section 221, page 1523, quotes from *Gray, Rule against Perpetuities*:

> "Estate for years, with a perpetual covenant for renewal, is, so far as questions of remoteness are concerned, substantially a fee, and as such it is so regarded."

For many different purposes the term "owner" is applicable to a lessee (see 29 Cyc. p. 1549, and particularly Note 28). We submit that the computation of income taxes is one of those purposes, where the circumstances are such as appear in this case.

A.

EVERY REASON FOR ALLOWING THE DEDUCTION TO AN OWNER OPERATING HIS OWN PROPERTY APPLIES EQUALLY TO THE LESSEE IN THE PRESENT CASE.

An owner of property, using it up in his business, must recover its cost or other basic value *as he uses it up*, and not when he gets it, when he pays for it, when he finishes using it up, or when he replaces it. This necessarily follows from the theory of the *Ludey* case. The consumption of property in lucrative business constitutes a gradual sale of the property. The sale price received includes a return of the capital. The capital is returned over the entire period of use, and should be excluded from taxable income ratably as the receipts from its use come in. Even if an owner keeps his accounts and makes his tax returns on a strict basis of cash receipts and disbursements he is required—always was required by the Treasury Department even before the *Ludey* decision—to *capitalize and depreciate* his capital assets. He is never permitted to charge them to expense at the time of acquisition or at the time of disposition, for to allow him to do so would not properly reflect his income.

If a man buys a machine with a five year normal life for $5,000, he will not be allowed to deduct $5,000 in that year. Nor will he be allowed to ignore depreciation and on selling it at the end of the fourth year for $1,000, take a deduction of $4,000 all in one year. That was in effect what was attempted in the *Appeal of Even Realty Co.*, 1 B. T. A. 355, referred to by this Court in the *Ludey* case, 274 U. S. 295 at 300.

The reason for not only allowing but compelling an owner to charge off his capital as he uses it up is be-

cause part of his receipts in each year constitute a return of capital, which is *not* income. And the rule is the same whether the owner has paid for the capital asset or is going to pay for it, whether title is in him or in his vendor or in a mortgagee. Whether the depreciation be regarded as a loss or a recovery of capital, it occurs gradually throughout the use of the property, and must be ratably deducted from receipts.

And this is equally true whether the taxpayer reports on a cash basis or an accrual basis. In the courts below the Government made a point that it did not appear of record that the taxpayer reported on an accrual basis. If he had been an owner instead of a lessee, the Treasury would not have permitted him to report any differently on one basis than on the other. We submit that it makes no difference in the case of a lessee.

If an owner, regardless of his bookkeeping method, must "depreciate" his property as he uses it up, regardless of when he makes the investment, we submit that the same should be true of a lessee.

If an owner bought property, to be paid for at the termination of its useful life, giving security for payment, he would not be allowed to take a single deduction at time of payment.

The reason given is that the lessee has made no prior investment. No prior investment is required of an owner who bought on credit, or who acquired his capital by gift or inheritance.

The owner is not allowed to charge to expense all in one year a capital asset the value of which will come back to him through gradual sale over many years. The reason given is that such accounting will not fair-

ly reflect income—his receipts for all the years will include returns of capital which should be excluded from income, and his outgo in the year of payment will include a *capital* item not a proper charge against that year's income. There is no difference in the case of the lessee.

To say to a lessee of a $100,000 building that he must pay taxes on $2,000 recovery of capital in each of forty-nine years, and then take a deduction of $100,000 in the fiftieth year against an income of maybe $10,000, is obviously unjust. He will show no tax for the fiftieth year. Suppose (as under present statutes) he can carry his net loss over the two following years, and wipe out say $10,000 of income in each year, he will still have a net loss of $70,000 for which he can get no credit. He will have been taxed on $70,000 of capital recovered in the first 49 years. This tax will have been levied without apportionment, in violation of the Constitution. *Eisner* v. *Macomber*, 252 U. S. 189, 206.

B.

EVERY REASON FOR DENYING A DEDUCTION FOR DEPRECIATION TO A LESSEE WOULD APPLY EQUALLY TO AN OWNER.

The principal reason given by the Government for its position is that the lessee has made no investment in the property which is wearing out. Many Owners acquired their property by gift or inheritance, making no investment, but under the Revenue Act of 1918 they were allowed depreciation deductions on the basis of the value of the property at time of acquisition. Many other owners acquired property prior to 1913 for a small fraction of the value at March 1, 1913, but their

depreciation is computed not on investment but on the value at March 1, 1913. Others acquired property on credit and paid for it as they used it up or after using it up. Their depreciation deductions were allowed without reference to prior investment.

The Government thinks that justice will be done by allowing the lessee to deduct the entire cost of a building in the year of its replacement. Why would this not be equally true with an owner?

If a lessee had so many buildings under lease that he had to rebuild one or more every year at a fairly constant annual cost, his deductions for replacements (under the Government's theory) would approximate his deductions for depreciation under our theory, and possibly no injustice would result to him from the application of the Government's theory. But the same would be equally true of an owner of many buildings—nevertheless we have no doubt that the decision in the *Ludey* case would be applied to such an owner if he attempted to charge off the entire cost of one of his buildings in one year.

The Government suggests (and its suggestion was followed by the District Court) that the lessee's liability for depreciation is *contingent*. It is pointed out that several of the respondent's leases were surrendered between the taxable years under consideration and the trial in this case. But the Treasury Department has always held that subsequent events have nothing to do with the computation of depreciation for a given year.

Suppose an "owner" bought a building on credit, giving a mortgage for substantially all of the purchase price. He would be allowed depreciation regardless of

the fact that he might default and reconvey (in lieu of foreclosure) without paying for the property, or that he might sell at a profit and pay his vendor out of the proceeds—or regardless of the fact that he had so defaulted or sold before finally settling his income taxes for the years he held the building. In such case he would have a taxable gain on selling or surrendering the building which would in effect include the depreciation reserve which then became income to him (*Appeal of Even Realty Co., supra*) for his "cost" would be reduced by the depreciation accrued. (*U. S. v. Ludey, supra*). The possibility of sale by an owner before his building is used up is in effect identical with the possibility of assignment or surrender by a lessee. Why does not the Treasury deny depreciation to owners until this "contingency" is resolved?

If the lessee in our case surrendered leases without turning over his depreciation reserve to his lessors it was probably because an increment in the value of the leases made the lessors glad to accept surrender on those terms. The surrender, and retention of the depreciation reserve would constitute a realization by the lessee of that increment, on which, for all the record shows, he paid income taxes—if he did not he should have. Similarly if he sold the leases to third parties.

The suggestion was made below that if the lessee were permitted to charge depreciation currently under Section 214 (a) (8) of the Revenue Act of 1918, he might later claim a deduction for replacements under Section 214 (a) (1) and thus duplicate the deduction. But it would be equally easy for an owner to take a deduction under Section 214 (a) (8) and later another under Section 214 (a) (6). There is no more reason for

misinterpreting the statute and doing injustice because of the possible future dishonesty of a lessee than of an owner.

IV.

THERE IS NO AUTHORITY FOR THE GOVERNMENT'S POSITION.

The opinion of the Circuit Court of Appeals in this case seems to us well reasoned and sound. In the absence of controlling decisions by this Court or conflicting decisions by other Circuit Courts of Appeals, it certainly is entitled to more weight than the decision of the District Court or any decisions of the Board of Tax Appeals or the Bureau of Internal Revenue.

But the Government claims that it conflicts with expressions by this Court in *Duffy* v. *Central Railroad of New Jersey*, 268 U. S. 55, and *U. S.* v. *Ludey*, 274 U. S. 295. We submit that both of those decisions favor our contentions.

In the *Central Railroad of New Jersey* case this Court held that the lessee could not charge additions and betterments to expense in the year in which they were paid for, indicating that they should be written off by annual charges for depreciation. While we fail to see the parallel between an addition or betterment, and the replacement of an outworn building, used up in the lessee's business, we are willing to accept it for the purposes of argument. If the additions are written off over a term of years, any replacements of them will be made out of the depreciation reserve, and *not* charged to expense at time of replacement—otherwise there would be a double deduction. If our lessee is supposed to follow the same rule and charge off replacements by

annual deductions over their life, he cannot also charge their entire cost to expense at the time of replacement. The Government would have him use up one building without any deduction, replace it without deduction (if the *Central Railroad* case applies) and then recover the cost of the second building through depreciation. But the money he spent for the second building and recovered by depreciation would have to be put into a third building for him to surrender at the end of the lease. He would spend it for himself but recover it for his lessor. At best he would have a deduction for loss at the end of the lease for the cost of one building—a deduction with no income to deduct it from. He would have paid taxes on capital as shown above at pp. 13 and 14.

If the Government's idea is that he could deduct the entire cost of the first replacement in one year, and then also take depreciation over the life of that building (which depreciation fund would of course eventually go back to the lessor), he would still be in the position of losing the benefit of the greater part of his deduction for replacement through having insufficient income in that and the next two years to offset it. And he would have paid taxes on all the capital recovered in the first forty-nine years.

The Government quotes from the *Ludey* case the words:

> .... The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the use-

> ful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide *an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold.* * * *." (Italics supplied in Government's brief.)

The words "original cost" and "the cost of the part which has been sold" are relied on as indicating that there must have been a previously paid cost to the taxpayer claiming the deduction. Of course the Court was dealing with a case not involving the question of *whose* cost it might be. The taxpayer in that case was the owner and had paid for the property. Had the owner acquired the property by inheritance or gift, we have no doubt the Court would have referred not to cost, but to basic value—the value at time of acquisition of the capital asset it found him to have sold gradually. If he had bought the property on credit and not yet paid for it, we have no doubt the Court would have regarded the price he had contracted to pay as the capital to be recovered by depletion and depreciation allowances. In our case each building had a determinable value at the time the lease was made. The lessee contracted to maintain that value and to restore to the lessor a building of that value (in some of the leases a considerably greater value). That value was the value to him of what he was gradually selling. To that extent he entered into possession of property for the purpose of selling it. The ratable proportion of that value he sold in each year was what he regarded as a recovery of capital and claimed as a depreciation

deduction. The very theory of the *Ludey* case—that the use of a building in business is a gradual sale of the building—is directly opposed to the Government's theory and is the basis of ours. The sale of a capital asset (whether paid for or not, whether owned or leased) involves a recovery of capital, which must be deducted, in the computation of income, *as the sale takes place*, from the receipts on sale.

The Government refers to several decisions of the Board of Tax Appeals. We regard them all as distinguishable but do not wish to burden this Court with the distinctions—for even if they were in point and adverse to our contentions we should merely urge that, on the reasoning we submit, they must be overruled. In one of them, *Appeal of Brevoort Hotel Co.*, 1 B. T. A. 132, the Board did say:

> "In a proper case, it may well be that although no outlay has been actually made, the commitments and obligations of the taxpayer are such as justly to entitle him to the deduction in accordance with the statute."

The Government cites a number of Regulations to show that the interpretation it places on the statute has had congressional approval by the enactment of subsequent statutes in the same language as the Revenue Act of 1918. That might support an argument that the *subsequent* acts should be interpreted in the light of Regulations 45, but constitutes no basis for interpreting the Revenue Act of 1918 which preceded Regulations 45.

Furthermore the regulations themselves, as shown above, merely refer to *property used in the business*,

and to cost or other basic value, without saying anything about ownership or whole cost.

Several "Office Decisions" are cited to show long continued departmental construction. Examination of them demonstrates that only one, O. D. 1014, 5 Cumulative Bulletin 151, has anything to do with the present question. It contains no reasoning but is an arbitrary statement that depreciation cannot be allowed to the lessee. For all the reasons given in support of our position, it is erroneous. And under the statement published by the Commissioner of Internal Revenue as a preface to every Internal Revenue Bulletin, it is not to be regarded as authority except on its exact facts. Furthermore, we have been advised (by the counsel for the taxpayer in whose case it was written) that it was not enforced in the very case in which it was made, but was reversed by the Committee on Appeals and Review, whose order of reversal, for some undisclosed reason, was never published by the Treasury Department.

Certainly there has been no such long continued and generally accepted departmental construction as to acquire the force and effect of law. *Iselin* v. *U. S.*, 270 U. S. 245, 251.

CONCLUSION

The decision of the Circuit Court of Appeals in this case, 27 Fed. (2nd) 200, is correct and accords with the understanding which businessmen have concerning the elements of cost entering into a business such as that conducted by the lessee under ninety-nine year leases renewable forever, sometimes referred to as perpetual leases, who sublets the buildings on the leased premises to various tenants. His costs include

a. The rent which the lessee under the perpetual leasehold pays to the landlord,

b. The taxes and assessments which he is required to pay,

c. Insurance,

d. Repairs and other expenses in keeping up the property, and

e. The annual depreciation occurring year by year and in spite of repairs, which will ultimately obligate the lessee under the perpetual leasehold to replace the building after it has become depreciated and obsolete.

In anticipation of this replacement, there should be an annual deduction for depreciation from the revenue obtained from the buildings on the leased premises. The amount of this annual depreciation is not income and it should not be taxed as income.

Justice cannot be done to a lessee taxpayer unless he be allowed to deduct the amount of this depreciation before arriving at his taxable income.

Respectfully submitted,

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